DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 03-0322
Indiana Gross Income Tax
For the Years 1998, 1999, and 2000

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ISSUES

I. Money Received from the Sale and Installation of Material Handling Equipment – Gross Income Tax.

Authority: U.S. Const. art. I, § 8; IC 6-2.1-2-2; IC 6-2.1-3-3; Indiana Dept. of Revenue v. Brown Boveri Corp., 439 N.E.2d 561 (Ind. 1982); Mueller Brass Co. v. Gross Income Tax Division, Indiana Dept. of Revenue, 265 N.E.2d 704 (Ind. 1971); Indiana Dept. of Revenue v. Surface Combustion Corp., 111 N.E.2d 50 (Ind. 1953); Gross Income Tax Division, State of Indiana v. Fort Pitt Bridge Works, 86 N.E.2d 685 (Ind. 1949); 45 IAC 1-1-120; 45 IAC 1-1-120(1)(c); 45 IAC 1-1-121(b); 45 IAC 1-1-121(d); 45 IAC 1.1-3-3(a); 45 IAC 1.1-3-3(c)(6); 45 IAC 1.1-3-3(d).

Taxpayer argues that it does not owe gross income tax on money received from the sale and installation of material handling equipment sold to Indiana customers because the transactions took place within interstate commerce.

II. Abatement of Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer claims that its failure to pay Indiana gross income tax was attributable to the complexity of the tax issues and that taxpayer exercised reasonable care, caution, and diligence in determining that it did not owe gross income tax.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of manufacturing conveyor systems or "material handling" equipment used by manufacturing companies including companies located in Indiana. The conveyor systems include accumulating conveyors, gravity roller conveyors, belt conveyors, automated storage devices, retrieval systems, and skid systems. Taxpayer states that it manufacturers the conveyors systems at one of its out-of-state locations. Due to the size of the systems, they are shipped to the customer in pieces by means of common carrier where the components are assembled and installed at the customer's location. Taxpayer generally sends one of its "project teams" to the customer's location to supervise the installation pursuant to the parties' sales contract. The project team typically consists of a project manager, field supervisor, and one or more engineers. The project teams are assisted by local union workers.

The Indiana Department of Revenue (Department) conducted an audit review of taxpayer's tax returns and business records. The audit found that taxpayer did not report gross income on the money it received from its Indiana customers. Taxpayer failed to report gross income tax at either the high rate or the low rate. The audit concluded that taxpayer had established an Indiana "business situs" by virtue of the "services provided to their customers" and that taxpayer should have been paying gross income tax on the money it earned from the initial sale and installation of the conveyor systems and the money it earned from the performance of post-installation service and repair work. Following completion of the audit report, the Department sent notices of "Proposed Assessment" for 1998, 1999, and 2000 taxes. The taxpayer disagreed with the audit's conclusions and the proposed assessments. Taxpayer submitted a protest to that effect, an administrative hearing was conducted during which taxpayer further explained the basis for its position, and this Letter of Findings results.

DISCUSSION

I. Money Received from the Sale and Installation of Material Handling Equipment – Gross Income Tax.

Taxpayer is a "material handling specialist" which sells conveyor systems. Taxpayer states the conveyor systems are made of "interchangeable standard stock." The standard stock is manufactured outside of Indiana, delivered by means of common carrier, and assembled and installed at Indiana locations by a team of its own employees who oversee the project and by local union workers. However, there is no indication that a material handling system is ever entirely pre-assembled at taxpayer's out-of-state location. After the conveyor system is installed at the Indiana site, taxpayer provides maintenance, product support, and service.

The conveyor systems are designed to move a variety of items such as newsprint, airline luggage, partially assembled automobiles, and bulk coal. Some of the conveyor systems are designed to move parts and materials before manufacturing occurs. Some of the conveyor systems are designed to transport partially assembled items while manufacturing actually occurs. The conveyor systems vary in design, function, and complexity.

The conveyor system can be as simple as an overhead track on which the load is pushed and maneuvered by hand.

The conveyor system can be an automatic monorail system consisting of switches, overhead sections, and accumulators on which the load is automatically identified and routed along complex paths to different track levels.

The conveyor system can consist of independent tow cars which are computer controlled and automatically routed along tracks embedded in the factory or warehouse floor.

The conveyor system can consist of track-less "automatic guided vehicles" which uses a "sophisticated network of encoded electronic signals" to transport product from one point in the customer's facility to another. Taxpayer states that these particular devices "can be designed to meet the demands of a broad scope of industries including health care, discrete manufacturing, primary metals, and aerospace."

Taxpayer's conveyor systems can be as sophisticated as an entirely integrated storage and retrieval system in which an automatic retrieval device moves through and within a complex, multi-level, densely structured storage facility. The automatic retrieval system locates, identifies, and retrieves a specific item of the customer's inventory and delivers that item to a designated point. The automatic retrievers "utilize state-of-the art software, infrared distance measuring devices and incremental encoders to operate quickly and precisely."

The audit assessed high rate gross income tax on taxpayer's service and installation income. The audit assessed low rate gross income tax on material sales. Taxpayer claims that the sales of the conveyor systems are not subject to gross income tax because the sales occurred in interstate commerce and because the related services are part and parcel of the interstate sales.

Indiana Gross Income Tax (IC 6-2.1-0.6 to 6-2.1-8-7) "is imposed upon the receipt of: (1) the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana; and (2) the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident of Indiana." IC 6-2.1-2-2 To assure that only income properly subject to a state tax is assessed Gross Income Tax, IC 6-2.1-3-3 provides that "[g]ross income derived from business conducted in commerce between the state of Indiana and either another state or a foreign county is exempt from gross income tax to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution." IC 6-2.1-3-3 was passed in recognition of the fact that the Commerce Clause requires that Indiana not unduly burden commerce between the states. Therefore, Indiana may not impose a tax that discriminates against interstate commerce in favor of intrastate commerce. "While a state may impose a tax burden that is reasonable in light of the incidence of commercial contact by the taxpayer with [the state], a tax system which may produce a multiple taxation burden is proscribed." Mueller Brass Co. v. Gross Income Tax Division, Indiana Dept. of Revenue, 265 N.E.2d 704, 717 (Ind. 1971).

Taxpayer argues that the Indiana sales in question fell within the protection afforded by the Interstate Commerce Clause which reserves to the federal government the power to "regulate Commerce . . . among the several states . . . ." U.S. Const. art. I, § 8. More specifically, taxpayer – for the first of the three years at issue – cites to 45 IAC 1-1-120(1)(c) which exempts from the Gross Income Tax certain sales made by non-residents to Indiana customers in which the out-of-state sellers perform installation services intrinsically related to the original sale. In regard to "Nontaxable in-shipments," the regulation states that, "As a general rule, income derived from sales made by nonresident sellers to Indiana buyers is not subject to gross income tax unless the seller was engaged in business activity within the state and such activity was connected with or facilitated the sales." 45 IAC 1-1-120. Specifically, the regulation exempts those sales "made by a nonresident where the product sold is, because of its size or weight, shipped in parts; and the seller, because of his special skill or expertise, assembles or installs the product at the buyer's place of business with no additional services rendered." 45 IAC 1-1-120(1)(c). Taxpayer maintains that Indiana may not tax the money it received during 1998 because that Indiana source income is protected by the Interstate Commerce Clause and falls within the definition of 45 IAC 1-1-120.

The Department promulgated new regulations governing the state's Gross Income Tax. Those new regulations became effective January 1, 1999, and govern taxpayer's 1999 and 2000 Indiana income. Taxpayer maintains that the state may not tax its 1999 and 2000 Indiana income because that money falls within the definition of "Gross income derived from business conducted in interstate commerce . . . ." 45 IAC 1.1-3-3(a). Taxpayer cites to 45 IAC 1.1-3-3(c)(6) in support of its position. That portion of the regulation requires, in part, as follows:

> Gross income derived from the sale of tangible personal property in interstate commerce is not subject to the gross income tax if the sale is not completed in Indiana. The following examples are situations where a sale is not completed in Indiana prior to or after shipment in interstate commerce . . . (6) A sale, not otherwise taxable, to an Indiana buyer by a nonresident where the seller, because of its special skill or expertise, assembles or installs the product at the buyer's place of business without any additional services being rendered. In other words, the services performed are part of the sale and the sale is exempt because it is in interstate commerce.

Taxpayer also cites to Indiana Dept. of Revenue v. Surface Combustion Corp., 111 N.E.2d 50 (Ind. 1953) for support of its contention that the sale of the material handling equipment to its Indiana customers took place within interstate commerce and the proceeds are exempt from the Gross Income Tax. In Surface Combustion, appellee taxpayer was an Ohio based furnace manufacturer. It sold furnaces to an Indiana customer, was assessed Gross Income Tax on the income derived from the sales, and brought an action seeking a refund of those taxes. The court determined that appellee taxpayer had constructed the furnaces at its Ohio facility. Thereafter, appellee taxpayer transported the smaller furnaces to the Indiana customer's site. The larger furnaces were assembled at the Ohio facility, disassembled, and shipped to the Indiana site; alternatively, the larger furnaces were only partially assembled at the Ohio facility before being "knocked down," transported and reassembled at the Indiana customer's site. In all cases, the court found that the "parties contemplated and intended that the furnace . . . should be shipped and transported from appellee's plant at Toledo, Ohio to the customer's plant in Indiana . . . ." Id. 53.

In Surface Combustion, it was the Indiana customer's responsibility to provide a foundation, plumbing, and electric wiring in preparation for the installation of the furnaces. Id. It was appellee taxpayer's own responsibility to provide the "specially trained factory engineers, supervisors, and workmen to assemble . . . install, align, and adjust all of [the furnaces] at the customer's plant in order to assure a proper functioning furnace which was necessary to consummate and complete the sale." Id.

In Surface Combustion, the court rejected the Department's contention that it was entitled to levy the Gross Income Tax against appellee taxpayer's income derived from the sale of the furnaces. The court found that, "the tax sought to be recovered was levied upon the gross receipts of appellee from interstate commerce transactions within and without the State of Indiana." Id. at 69. The court concluded that imposition of the tax "directly burdens, and interferes with, the free flow of such commerce between the State of Ohio and the State of Indiana and is invalid as being in conflict with Article I, of § 8 of the Constitution of the United States." Id.

The court found that the "thing" which the Indiana customer purchased from appellee in Ohio, was a "heat treating furnace complete in one functional unit." Id. at 62. In support of that conclusion, the court noted that, "There is no evidence that the furnaces were made, built, fabricated, created or brought into existence in Indiana." Id. The Indiana installation work performed by appellee taxpayer consisted "only in the reassembling and installing the furnaces which had been purchased in the State of Ohio and taken apart for the convenience of shipment." Id. Appellee taxpayer's in-state activity was "intrinsically related to and inherently a part of the sale; and because of their complexity their installation and testing was essential to the making of the sale." Id. The sales of the furnaces were "clearly sales of personal chattels in interstate commerce and the installation and reassembling where required, were inherently a part of, and a necessary incident to, the sale." Id.

Taxpayer also cites to Indiana Dept. of Revenue v. Brown Boveri Corp., 439 N.E.2d 561 (Ind. 1982) in support of the proposition that sales of material handling equipment is not subject to the Gross Income Tax. In Brown Boveri, plaintiff taxpayer was an out-of-state company which had entered into a contract with an Indiana manufacturer for the sale of an induction melting system. The parties' sales agreement was for the "turn-key" delivery of a system that would produce molten iron. "The system was pre-fabricated at [plaintiff taxpayer's] plant, broken down for shipment and reassembled at the [Indiana customer's] plant." Id. at 563. Plaintiff taxpayer conducted certain activities at the Indiana site because it "was necessary for [plaintiff taxpayer] to engage in various activities to guarantee proper planning and coordination of the project." Id. Plaintiff taxpayer's in-state activities "included reassembly of the equipment, removing obsolete equipment, pouring foundations, trenching, and reinforcement of existing structures." Id.

The court disagreed with the Department's argument that plaintiff taxpayer's performance of activities within Indiana removed the transaction from the protection afforded interstate commerce. Id. at 564. The court found that the transaction between plaintiff taxpayer and the Indiana customer was "indeed interstate commerce such that taxation of gross income resulting therefrom [was] prohibited." Id. The transaction was for the "sale of a functioning system for a lump sum," in which "all of the component parts were pre-fabricated outside Indiana, disassembled for shipment, and then reassembled on the job site." Id. Plaintiff taxpayer's local activities did not take the sale of the melting system outside interstate commerce protection because "the local activities of [plaintiff taxpayer] were intrinsically related to and inherently part of the sale in interstate commerce." Id.

In both Brown Boveri and Surface Combustion, the out-of-state taxpayer constructed equipment and then shipped that equipment – either piece-meal or as a complete unit – to the Indiana customer. The court found, in both instances, that the sale of the equipment was interstate in character while taxpayers' in-state activities – installing and testing the equipment – were inherently related to the original out-of-state sale.

Taxpayer's sale of its material handling equipment is not analogous to the transactions described in Brown Boveri and Surface Combustion. In Surface Combustion, the court stated that there was "no evidence that the furnaces were made, built, fabricated, created, or brought into existence in Indiana." Surface Combustion, 111 N.E.2d at 62. While the numerous individual components may have existed outside of Indiana, there is every indication that taxpayer's material handling devices were "made, built, created, [and] brought into existence in Indiana." Brown Boveri, 439 N.E.2d at 563. In Brown Boveri, the court found that, "The system was pre-fabricated at [taxpayer's] plant, broken down for shipment and reassembled at the [Indiana] plant." Id. The taxpayer's own material handling devices were not pre-fabricated outside the state, broken down for shipment, and reassembled at the Indiana customers' steel plant. Instead, the material handling equipment was not brought into existence until taxpayer transported the components to the site and then assembled those components into the device which taxpayer sold to the Indiana customers. Taxpayer's sales of material handling equipment were not interstate transactions with the taxpayer's performance of Indiana installation activities merely incidental to the sale of the material handling equipment. Taxpayer's customers did not buy out-of-state material handling equipment, arrange to have the equipment disassembled and shipped to Indiana, and then reassembled at the customers' site. Taxpayer entered into contracts to perform construction and assembly work in Indiana and thereby subjected itself to Indiana's taxing jurisdiction. Taxpayer's initial construction and completion of the material handling devices occurred in Indiana, and the proceeds are properly subject to the state's Gross Income Tax.

Taxpayer's sales of the material handling equipment are analogous to the activities of appellee manufacturer in Gross Income Tax Division, State of Indiana v. Fort Pitt Bridge Works, 86 N.E.2d 685 (Ind. 1949). In that case, the manufacturer – a Pennsylvania based corporation – arranged for the construction, fabrication, and assembly of certain buildings within the state. The manufacturer "furnished and fabricated the steel and shipped it from its plants in Ohio or Pennsylvania" to the customer's location within Indiana. Id. at 687. Thereafter, a subcontractor received the material and performed all the work necessary for the "construction of the buildings for which the steel was furnished." Id. The manufacturer treated the receipts as not subject to Indiana's Gross Income Tax because, according to the manufacturer, "it had nothing to do with the activity and business conducted in Indiana by [the subcontractor] and that it [was] not liable for tax upon the price paid for the steel and fabrication . . . because the fabrication occurred outside the state and furnishing the steel was an interstate transaction." Id. at 688. The court disagreed with the manufacturer's contention on the ground that, "A corporation which contracts in the state of its residence to do work in a foreign state subjects itself to the jurisdiction of such foreign state, notwithstanding it employs independent contractors to do the actual work and does no part of the actual work itself." Id. at 689. The manufacturer's income was subject to Indiana's Gross Income Tax because "[the income] was derived from an activity for which it was responsible. It came from its business in Indiana, carried on through the medium of a subcontractor acting independently as to the manner and method, but acting for [the manufacturer] in the accomplishment of the result which it contracted to bring about." Id.

The court rejected the manufacturer's argument that the transaction was interstate in nature because the court did not believe the contract "was a contract of sale with construction work in Indiana as a mere incident." Id. at 691. Even though the component parts were initially manufactured at an out-of-state location, "the transaction as a whole was local in nature and subject to local tax and regulation." Id. The court stated that it had "no hesitance in saying that the State of Indiana [had] the right to apply its gross income tax to business actually transacted within its borders, notwithstanding that interstate commerce, as an incident, may have intervened in at some point in the transaction . . . ." Id. at 692.

Taxpayer manufactured and pre-assembled certain, individual components at its out-of-state location. Other components were purchased from third-party vendors predominantly located outside of Indiana. These components were then delivered by common carrier to the Indiana customer's location. The various component parts were finally assembled and incorporated into the completed material handling device. Taxpayer hired local workmen to perform much of the on-site work. However, "Taxpayer's skill and expertise were required to assemble and install the equipment/systems." To that end, taxpayer sent a project manager, field supervisor, and one or more engineers to oversee the fabrication and installation process. As taxpayer explained, "Taxpayer's engineer(s) were the only person(s) that possessed the knowledge and expertise to supervise the assembly of the component parts into the completed material handling lines."

The taxpayer's 1999 and 2000 transactions fall within the purview of the state's Gross Income Tax scheme as set out in 45 IAC 1-1-121(b) which states that:

> Gross receipts from the performance of construction projects in Indiana are subject to gross income tax. This is true even when the contractor is a nonresident and even when he subcontracts all Indiana work to local businesses and has no other contact with the state except to ship goods manufactured elsewhere into the state for installation by local workmen.

Taxpayer's Indiana activities are not merely "incidental services taking place within the State, which may be tax-exempt as a transaction in interstate commerce." 45 IAC 1-1-121(d). Taxpayer is not merely setting the equipment "on bases or connecting to pipes, supports, etc., provided by the customer." Id. Rather, taxpayer clearly "performs additional services, such as installation, testing, construction, etc." thereby entitling the Department to treat the transaction as an Indiana "construction project" the proceeds of which are properly subject to the state's Gross Income Tax. Id. *See also* 45 IAC 1.1-3-3(d).

Taxpayer designs and builds sophisticated, complex material handling devices. Taxpayer enters into contract with Indiana customers to install the devices at Indiana locations. The devices do not exist until the components and subcomponents are assembled at the Indiana location. The money received from the sale and installation of the devices is subject to the state's gross income tax.

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of Ten-Percent Negligence Penalty.

Taxpayer asks that the “Department waive the imposition of the negligence penalty relating to the Department’s audit assessment.” Taxpayer does so because it believes that its “failure to pay [Gross Income Tax] does not stem from negligence, but rather from the complexity of the tax issues raised in the audit.”

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer’s negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to “be determined on a case-by-case basis according to the facts and circumstances of each taxpayer.” Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on “reasonable cause and not due to willful neglect.” Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish “reasonable cause,” the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . .”

While the contracts for the sale and installation of the material handling equipment arguably implicated activities related to interstate commerce, taxpayer’s determination that it had zero gross income tax liability during the three years falls outside a reasonable definition of “ordinary business care and prudence” and does not warrant abatement of the associated penalties.

FINDING

Taxpayer’s protest is respectfully denied.

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